CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 276

November 2, 1964

JOINT VENTURE: INCOME DERIVED FROM JOINT VENTURE PROPERTY AFTER TERMINATION OF JOINT VENTURE

Syllabus:

A, B, and C Corporation formed some fifteen joint ventures between the years 1953 and 1957. Each joint venture was formed to produce a single motion picture. Pursuant to one of the terms of the joint venture agreement, each joint venture entered into a distribution agreement with C.

The joint venture agreement provided for sharing of profits and ownership of assets in specified proportions. The agreements also provided that the joint venture should continue until the expiration of C's distribution rights under the distribution agreement, and thereafter until the sale of the property, or its acquisition by one of the members.

Agreements were subsequently entered into to terminate the joint ventures prior to the expiration of the term provided in the agreements forming the joint ventures. For example, the members of the joint venture formed December 10, 1953, executed among themselves and with C, as a party to other agreements, an agreement dated June 3, 1958, to terminate the joint venture on June 28, 1958. The agreement provided that after termination of the joint venture the parties should hold the property as tenants-in-common in the same proportion as their interest in the joint venture, subject to all the terms and conditions of agreements executed by the joint venture, and the parties agreed to perform any obligation and fulfill any commitments that would have been required of the joint venture. The termination agreement deleted any provisions in former agreements referring to "profits", but, in effect made no change in the proportionate sharing of the proceeds from the distribution of the motion pictures by A, B, and C.

Prior to the use of the joint venture arrangement, A and B operated in corporate form as A-B, Inc. The corporation entered into distribution agreements with C just as did the subsequent joint ventures. The question arose as to the amount of the corporation's income that was allocable to California for the years 1949 and 1952. An appeal was taken to the Board of Equalization, but a solution was negotiated and the appeal dismissed.

A is not a resident of California and is subject to personal income tax only on income from sources within the state. Accordingly, an opinion is requested as to whether the income that continues to be derived from the motion pictures produced by the same joint ventures retain its sources in California to the same extent as if derived by the joint ventures. If so, what method should be used to determine the amount of income derived from or attributable to sources in California. If not, does A have income from sources in California due to the showing in California of motion pictures owned by him as a tenant-in-common. In view of our conclusion on the first question, the last question need not be answered.

(1) Where the joint venture is terminated by mutual agreement of the members but income continues to be derived by them from the property produced by the joint venture, should such income be treated in the same manner as if the joint venture continued, for the purpose of determining the source of the income for taxation of a nonresident member of the former joint venture.

(2) If so, what method should be used to determine the amount of income from sources in California.

The taxpayer has engaged in the production and ownership of motion picture properties under three successive legal forms: corporate, joint venture and tenancy-in-common. In the case of the corporation, the California franchise tax is measured by the net income derived from or attributable to sources within the State (section 25101). The gross income of a nonresident who is a member of a joint venture (which is treated as a partnership) includes the member's distributive share of the net income of the joint venture to the extent that the member's distributive share is derived from sources within this State (1954 Regulation 17211-17214(a)(2)). Finally, as an individual sole proprietor, a nonresident is taxable only upon net income derived from sources within this State (1954 Regulation 17211-17214(a)(1)). 1954 Regulation 17211-17214(B) provides that income from sources within the State includes income from a business carried on within the State and Regulation 17211-17214(d) provides for an allocation if the business is carried on both within and without the State. The allocation is based on the same formula that is applied to corporations under Section 25101. Therefore, if a taxpayer, corporate or individual, is carrying on a trade or business, there is no difference in the method by which income from sources within the State is determined. However, if income of a nonresident individual is derived from the ownership of property, rather than from carrying on a business, the income is taxed by this State only if, in the case of tangible property, it has a business or taxable situs in the State. The question then is whether the taxpayer is deriving income from carrying on a business or whether he is deriving income merely from the ownership of property.

In the Appeal of A-B, Inc., the parties herein that subsequently formed the joint ventures were organized in corporate form to engage in carrying on the same activities that were subsequently carried on by the individuals in a joint venture. The question in that appeal was the proper allocation of the corporation's income to this State. In large part, the controversy was concerned with the allocation of sales based on the situs of the distribution agreement and the activities of A with respect to the distribution of the pictures. After considerable negotiation, allocations factors were agreed upon by the taxpayer and the Franchise Tax Board.

Since it appears that the activities of each joint venture and the profit sharing arrangement under the agreement terminating the joint venture are the same as existed under the corporate arrangement, it would seem that the source of the income should be deemed to be the same and that the same allocation would apply. It is difficult to perceive wherein the source of the income is altered by the execution of the agreement purportedly terminating the joint venture. Moreover, where personal property is produced within this State and is disposed of, in whole or in part, without the State it would seem that the income is derived partly from sources within and partly from sources without the State. (Compare Internal Revenue Code Section 863(b)(2)). It may also be argued that the income continues to be derived from the distribution agreement executed by the joint venture (Moyle v. United States (Ct. Cl.), 22 F. Supp. 432, 20 AFTR 908) which we contended in the case of A-B, Inc., has a situs in California.

If the income is subject to allocation, as concluded above, a joint venture return is required in order to consider the entire operation and make on orderly allocation. This cannot be done by each member separately, but rather requires an annual computation for the entire business operation. (See, 1954 Regulation 18301-18304(a); 1955 Regulation 17921(a)(1) and (2)(i); Senate Report, Estate of Appleby, 41 BTA 18, 21, fn. 2.)

It is concluded that in order to determine the amount of income that is derived from sources in California, the producers should file a partnership return for each picture to show the allocation of income within and without the State. The amount taxable to A, as a nonresident, can then be determined according to his percentage share of the income.

The conclusions reached in this opinion are not applicable to a corporate partner or joint venturer which together with the partnership or joint venture is engaged in a unitary business.